

### Getting inflation in Russia down: A tricky task

Hishow, Ognian N.

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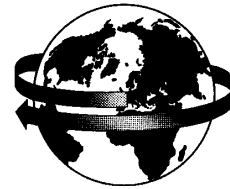
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## Aktuelle Analysen

Nr. 39/2000

8. November 2000

### **Getting Inflation in Russia Down: A Tricky Task**

#### **A Protectionist Environment and Restricted Competitiveness Feed Inflation**

##### **Zusammenfassung**

Rußland kämpft mit hohen Inflationsraten bereits seit dem Zerfall der Sowjetunion, wobei schon die zentralistische Wirtschaftspolitik inflationär geprägt war. Damals herrschte ein Ungleichgewicht zwischen Angebot und Nachfrage mit der Folge eines beträchtlichen Geldüberhangs, welcher nach der Freigabe der meisten Preiskontrollen durch die Regierung Gajdar zu einer Preisexplosion führte. 1992 gab es Hyperinflation und erst 1998 gelang eine deutliche Rückführung des Preisindex. Doch im selben Jahr brach der Wechselkurs des Rubels zusammen und es folgte eine erneute schwere Rezession mit rasch steigenden Inflationsraten. Inzwischen hat sich die Wirtschaft jedoch wieder erholt und die Zentralbank in Moskau prognostiziert eine Preissteigerungsrate um 12% für 2001 – und damit weniger als die voraussichtlichen 20% in diesem Jahr. Damit ist aber der geldpolitische Spielraum ausgeschöpft: Während ein stabilisierter Rubel eine deutliche importierte Inflation derzeit ausschließt, lassen die hohe Monopolisierung und der geringe Offenheitsgrad der Wirtschaft das Ziel einstelliger Inflationsraten in weite Ferne rücken.

Inflation in postcommunist Russia has a long history beginning back in the Soviet era. An imbalance between supply and demand caused a huge money overhang, which fed through into a price explosion after the government of Egor Gaydar abolished most of the central price controls in 1992. The economy promptly slid into hyperinflation and the government struggled until 1998 to reduce the price index. But in the summer of that year the nominal ruble anchor collapsed and triggered another heavy depression, boosting inflation again. Currently, price growth is slowing down and the Central Bank forecasts an inflation rate of about 12 percent next year, down from the 20 percent that it at times reached in 2000. While a more stable ruble rules out large-scale imported inflation, the economy's high level of monopolization and limited openness to foreign investment/trade suggest a protracted battle to rein in price growth.

##### **The sources of recent price growth in Russia**

After the ruble crisis in August 1998 domestic prices soared, mainly because imports suddenly became much more expensive. At that time private consumption's share of the gross domestic product (GDP) was roughly 50 percent, and private households were spending about half of their disposable income on food and beverages. Moreover, 40 percent of all food consumed was imported, so imported items for

private consumption accounted for at least 10 per cent of GDP.<sup>1</sup> As the dollar exchange rate tripled overnight, the inflation rate immediately reached an estimated 30 percent, solely because of the heavy dependence on food supplies from abroad (demand for food does not vary very much with changes in price and constitutes a large share of overall consumption). Later the weak ruble facilitated more import substitution, while the monetary authorities managed to stabilize the exchange rate, thus reducing the impact of foreign trade on inflation.

The federal budget balance – another key indicator – improved too. During the shaky post-crisis months the deficit soared once again after it had been somewhat reduced in summer 1998. It peaked in December of the same year at a worrisome – but to date unmatched – 5 percent of nominal GDP, forcing the Central Bank to extend credits to the government and thus to increase the money supply. As output simultaneously contracted, the additional money fed through into higher prices. But later a miracle occurred, and the budget became more balanced, eventually achieving a respectable surplus. In the first half of 2000, for instance, the surplus reached between 4.5 and 7 percent of nominal GDP, thus releasing the Central Bank from the need to finance the government.

Although it is no longer necessary to print more money, the budget plan predicts double-digit inflation next year. So why are prices continuing to rise? The situation might not be so confusing if one were able to consider downward inflation as a trend, i.e., as a steady decline in the price level, GDP deflator and the like. In Russia, indeed, it has been lower in 2000 and looks set to diminish further in 2001. But such trends are rarely certain. The experience of curbing inflation is pretty varied – there are examples of a sudden change in inflation expectations and thus in inflation itself. A typical case is the introduction of a currency board, whereby the money supply is "outsourced" to a foreign central bank to rule out any excessive growth in the money base. Any other strictly austerity-based monetary policy may lead to a radical curb in price growth too. However, central banks and governments seldom use radical approaches, let alone in countries with a long-lasting depression or recession. On the contrary, they incline towards a smoother policy to avoid stifling an upcoming nascent recovery, and the Russian government is no exception.

Yet history teaches that combating hyperinflation is sometimes easier than reducing single-digit inflation rates. While welcoming an overall decline in the inflation rate, interest groups often resist further (as a rule real-sector) measures which may cut their rent they draw from a privileged position in the economy. Other things being equal, in such an environment of protracted reform expectations resist to change, elimination of inflation turns out to be an arduous task. Therefore, while the root of the problem may be monetary, inflation in Russia may also result from factors in the real sector. Usually, these concern the level of monopolization and the openness of the economy. The less domestic competition there is and the lower the share of tradable goods in total output, the more stubborn inflation is likely to be.

### The obstacles

Since the introduction of the economic reforms much has happened in the Russian economy. Sectoral shifts have taken place in which industry lost out to the service sector. The bulk of newly established companies are located in services, although private firms perform well in other sectors too. The core sectors of the economy, however, are still dominated by old-style monopolies, which is due partly to technology and the need for capital centralization and partly by the lack of pressure for change. Thus, in the oil extracting and refining industry only big companies can survive, while in railway transportation and power generation there is no space for alternative grids. The problem is that in Russia private

<sup>1</sup> Fifty percent consumption  $\times$  0.5 food items (in money terms),  $\times$  0.4 food imports = roughly 10 percent of the GDP accounted for by food imports.

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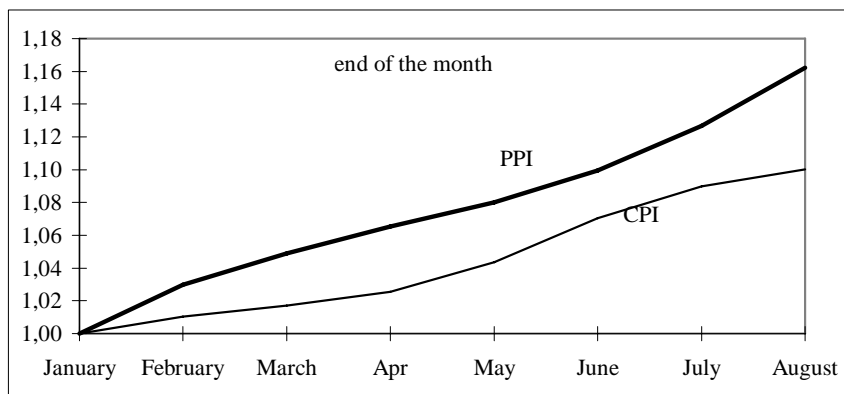
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monopolies do not face international competition, whereas the so-called natural monopolies<sup>2</sup> still enjoy protection. While in bad times producers usually refrain from raising prices, in good times they demand more for their products. In such a situation the producer price index (PPI) outpaces the consumer price index (CPI), signaling forthcoming inflation. Russian data appear to prove this: between mid-1998 and the first quarter of 1999 the PPI lagged behind growth in consumer prices. More precisely, an apparent difference occurred during the crisis of August 1998 and its aftermath, as the margin between the two indices widened sharply. Whereas producer prices almost stagnated, the consumer price index displayed monthly growth rates of up to 38 percent.

However, after the economy picked up things changed. Beginning in spring 1999 the price growth pace inverted and producer prices speeded up, albeit with bigger fluctuations, and clearly outpaced the CPI in 2000 (Diagram 1).

Diagram 1: Weighted producer (PPI) and consumer (CPI) price indices 2000



Sources: Russian economic trends (RET), Monthly update, September 2000, Table 8 ([www.hhs.se/site/ret](http://www.hhs.se/site/ret)); Banking & Finance weekly report, Interfax information services B.V., September 29, p. 6.

However, a more accurate investigation of the circumstances causing inflation reveals how convincingly market forces work in Russia. One only needs to survey price developments in the food, retail and industrial wholesale sectors. Retail prices for food went up in the first half of 2000 very moderately, even compared with the weighted PPI, because fierce competition here strictly narrows profit margins. Conversely, the improved income situation of consumers caused prices for non-food goods and paid services to increase faster. They accelerated the PPI, while a possible "brake effect" of the slower growing food prices abated as the share of foods and beverages in overall household spending decreased parallel to the fast rise in real disposable income in the first half of the year.

In contrast, the industrial price index picked up, reflecting a positive business sentiment and the stronger position of industrial companies in the Russian economy, which has not been restructured comprehensively yet (Diagram 2). Within the industrial sector the biggest price hikes took place in natural gas production, followed by oil extraction. Oil prices increased partly as a result of the price explosion on the international oil market, whereas the gas price is linked to energy prices as a whole and follows the trend. The energy price rises also, however, reflect the monopoly profit the companies gain by exploiting their privileged position with low exposure to international competition. After all,

<sup>2</sup> In terms of micro-economics a natural monopoly may extend its marginal revenue without reducing the price, because there is no need to operate within a monopolistic competition. Examples of natural monopolies in Russia are the national railway company, the unified energy system, the gas monopoly Gazprom, and so forth.

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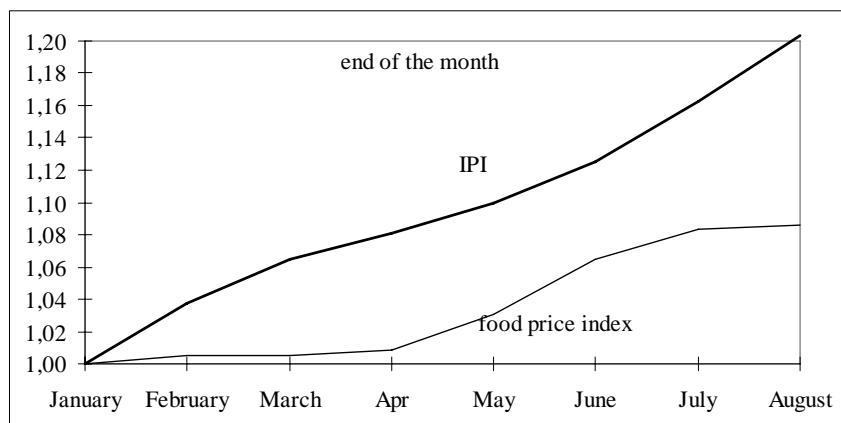
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oil prices rose more in oil extracting Russia than they did abroad.<sup>3</sup> Natural gas prices soared even more, by almost one half, fuelling suspicions that the gas giant Gazprom misuses its market power as the country's single gas supplier to dictate prices. Other monopolies probably did the same. Since the beginning of the year tariffs for freight forwarding by rail have risen by 41.3 percent, and for electricity by one-third. In branches with more competition tariffs rose by far less. For instance, in the fairly deregulated and less concentrated road transportation sector they went up by just 16.7 per cent.<sup>4</sup>

Thus, improved macro-economic performance helped to curb inflation, but the toughest test is yet to come. It is hard to believe that stabilization will succeed without cracking down on the interests of the notorious Russian oligarchs, red directors and Soviet-style policymakers. Now measures are urgently needed which target the micro-level, aimed at further opening up Russia to international investors while simultaneously encouraging domestic competition. With internationally traded goods and services making up a larger share of output, the margin between the nominal exchange rate and the exchange rate at purchasing power parities will narrow, making Russian stocks a more realistic and attractive opportunity to foreigners. Rising foreign direct investment may expose the economy more to international price levels and impede arbitrary price hikes by domestic monopolies. Since the latter are mainly controlled by the financial oligarchs who emerged from the collapse of the former USSR, driving these people out of business would mean greater stability and transformation success.

Diagram 2: Industrial (IPI) and food price indices 2000



Sources: RET, op. cit. Table 8; Banking&Finance weekly report, op. cit., p. 6.

### The curse of the lavish dollar inflow

The history of the Russian currency has mostly been a story of a legal tender which failed to gain confidence. The reason is that a constant nominal devaluation/depreciation of the ruble took place between 1992 and 1999. With respect to the US dollar and other western currencies, the ruble is now thousands of times cheaper than it was initially. Yet recently, in the wake of the sudden dollar windfall resulting from lavish export revenues, this depreciation tendency has increasingly turned into appreciation pressure, either in nominal or real terms. As just outlined, the Central Bank has managed to stabilize the nominal exchange rate, while the inflation rate remains relatively high, causing real appreciation. The current price growth arises – as explained – from the price policies of business on the one

<sup>3</sup> In January-August, 2000, crude oil spot prices went up from US\$ 27.3 to US\$ 37.6 per barrel or 37.7 percent. In Russia they increased by 41.4 percent (Sources: Banking&Finance weekly report, Interfax information services B.V., September 29, p. 6; BP, www.bpamoco.com).

<sup>4</sup> Source: ibid.

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hand and the money supply by the Central Bank on the other. Since the monetary authorities are not supposed to extend credits to the budget, the excessive growth of the monetary base right now reflects that same fortuitous dollar influx into the economy which helped to build up foreign exchange reserves. At the same time it poses a problem for the Central Bank. A proper sterilization may work for a while, but this tool is barely effective in a country where the bond market has collapsed and business securities are not seen as reliable instruments.

A ruble revaluation would help, but right now neither big business nor the Finance Ministry are very enthusiastic about such an idea. Both the export sector and companies involved in import competition reject a cheaper dollar, while fiscal plans are based on calculations in ruble terms, so a higher dollar exchange rate benefits budget revenues. At the moment the Central Bank seems to have decided to bow to business, since only a crawling ruble devaluation in nominal terms is foreseen for 2001. The drawback is that the resulting ruble appreciation in real terms will diminish the purchasing power of the dollar in Russia. This is likely to make exporters reluctant to repatriate their revenues or, put another way, it will encourage capital flight again. More capital export will go at the expense of the investment demand and thus of growth and recovery.

So the best policy seems to be the abolition of the compulsory conversion of export earnings into rubles while pursuing a reliable ruble-dollar exchange rate to keep attracting foreign investment.<sup>5</sup> With

<sup>5</sup> Foreign investors take account of the exchange rate in their calculations because it influences the returns on invested capital. Consequently, they prefer a forecastable one.

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Telefon 0221/5747-0, Telefax 0221/5747-110; Internet: <http://www.biost.de>  
E-mail: [administration@biost.de](mailto:administration@biost.de)

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inflation kept under control domestic and foreign business will be able to plan better, thus contributing to steady growth and helping the economy to overcome the crisis once and for all.

Ognian Hishow